MARKET LETTER

July 2021

Inflation Is Dead, Long Live Inflation

The market has had a fabulous start to the year. Halfway through 2021, the S&P 500 closed at all-time highs, up 15% on the year and 8% on the quarter. The full re-opening of the US economy is highly anticipated and reflected in the stock market's recent performance. Full-year GDP growth is estimated in the mid to high single digits, driven by pent-up consumer and corporate demand, fiscal stimulus and less distancing. Company profit margins are strong and poised to expand as productivity improvements achieved during Covid are likely to endure. This is a great testament to innovation driving US companies and the underlying strength of the US economy overall.

As the Delta variant gains traction around the world and even in certain regions of the US, continued economic gains are not assured. Market surveys show, however, and our own discussions with clients attest, that the biggest perceived market risk remains inflation, by a wide margin, and a close runner-up being the ominous and inescapable "Fed taper". The Federal Reserve, for its part, is sticking with its story that inflation is "transitory" and the bond market, with the 10-year stubbornly below 1.50%, seems to support the view that inflation will subside. In our view, it is good news that we see market conditions that would prompt higher rates and a tapering of easy economic conditions.

In the three months to May, core consumer prices, which exclude food and energy, rose at an annualized rate of 8.3%, the highest rate since the early 1980s. Everything from lumber to used cars and concert tickets saw big price increases, as demand vigorously picked up while supply chains and capacity lagged. Many of these big price moves were due to the pandemic and its aftermath: for instance, everyone is eager to travel at the same time that airline capacity is slow to ramp up. We are seeing a classic case of short-term dislocation in everything from airlines to concert venues to building materials. Thankfully, supply has ramped up to meet demand and prices have already started to stabilize in many commodities as well as for many services. As unemployment benefits and fiscal spending return to more normal levels, consumer pent-up demand will likely abate.

"This time is different" is a familiar refrain. The Biden and Trump administrations have pumped an unprecedented amount of liquidity in the economy and the fear is that major spending sprees by stir-crazy consumers will result in a classic case of too much money chasing after too few goods. The question is whether this is the start of a runaway inflation cycle, of which the Fed has already hopelessly lost control. The good news is that prices have already started to ease and, in the Fed's last policy statement, there was a decidedly more hawkish tone, a testament that the Fed would not sit idly by and watch inflation spin out of control. Just as the Fed was "out of bullets" when it was trying to spur growth and rates were near zero, it cannot also be "out of bullets" if it were intent on slowing the economy and rates are near zero. To date, the Fed has been correct in focusing on underlying inflation, as opposed to transitory inflation, as it did in the 2010-2011, when prices of oil and other commodities took off, but core inflation remained quite stable. A decade of low inflation, steady job gains and moderate GDP growth ensued. Then and now, the Fed is focusing on the very factors that have suppressed prices since the late 1980s, still very much intact in a post-pandemic world: weak demographics, technological advances and excessive debt levels.

Consensus shows inflation expectations at about 2.5% in each of the next few years. Wages rose 4.6% in June, above the 50-year 4% average, but, with equally big productivity gains, unit labor costs are flat. The US economy is producing more goods and services today than it did pre-pandemic, with 8 million fewer workers. As workers return to the labor force and jobs are filled, this could be a confidence and spending booster, a net positive for future GDP growth. As such, the possibility remains for a smooth hand-off between fiscal stimulus and private sector support without spurring runaway core inflation, a decidedly insidious and difficult disease to cure.

Even in the event of rising inflation expectations, the Alta portfolios are well-positioned, as equity revenue streams should benefit from rising prices and stocks with reasonable valuations tend to fare better as rates rise. In any event, after a very strong first half and with confidence indices at very high levels, we expect moderating returns over the second half for the market overall. We believe it will be more important than ever to focus on the merits and attributes of individual companies – a stock picker's dream.

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